IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 27.6.2006

CORAM

THE HON'BLE MR.JUSTICE P.D.DINAKARAN
AND
THE HON'BLE MR.JUSTICE P.P.S.JANARTHANA RAJA

T.C.(A).No.265 of 2001

The Commissioner of Income Tax
Tamil Nadu-IV,Madras. .. Appellant

Vs.

M/s. Rajam Ramaswamy & Sons
188, Poonamallee High Road
Chennai. .. Respondent

Appeal under Section 260A of the Income Tax Act, 1961 against the order of the Income Tax Appellate Tribunal, Madras 'A' Bench dated 14.7.1999 in ITA No.1619/Mds/1993 for the assessment year 1989-90 against the order of the Commissioner of Income Tax (Appeals) IX, Madras-34 in IT Appeal No.470/CC V(IPV)/1/1991-92 dated 15.2.93 against the order of Asst. Commissioner of Income Tax, City Circle V (Inv) Madras-34 in GI 2301/R/1989-90 dated 31.1.92.

For Appellant : Ms. Pushya Sitaraman, Sr.S.C.

J U D G M E N T

(Delivered by P.D.DINAKARAN, J.)

The above tax case appeal is directed against the order of the Income-tax Appellate Tribunal dated 14.7.1999 made in ITA No.1619/Mds/1993 for the assessment year 1989-90.

2. The assessee filed its return for the assessment year 1989-1990. The claim of the assessee for a sum of Rs.1,30,000/- paid to the partner was disallowed by the Assessing Officer under Section 40 (b) of the Income Tax Act and was added as the income of the firm. On appeal, the Commissioner of Income Tax (Appeals), following his earlier year's order, allowed the appeal directing the Assessing Officer to delete the addition, which was, on further appeal, confirmed by the Income Tax Appellate Tribunal.

3. Aggrieved by the same, the Revenue has filed the above appeal raising the following question of law.

> "Whether on the facts and circumstances of the case, the Appellate Tribunal was justified in holding that the payments made to the partners a sum of Rs.1,30,000/- by the

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assessee firm were not disallowed under Section 40(b) of the Income Tax Act, 1961?"

4. Before proceeding further, it is apt to refer the provision contained in Section 40(b) of the Act, so far as it is necessary for the purpose of this case.

> 40. Amounts not deductible.--Notwithstanding anything to the contrary in sections 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession",--
>
> (a) ...
> (b) in the case of any firm assessable as such,--
>
> (i) any payment of salary, bonus, commission or remuneration, by whatever name called (hereinafter referred to as remuneration) to any partner who is not a working partner; or
>
> (ii) any payment of remuneration to any partner who is a working partner, or of interest to any partner, which, in either case, is not authorised by, or is not in accordance with, the terms of the partnership deed; or
>
> (iii) any payment of remuneration to any partner who is a working partner, or of interest to any partner, which, in either case, is authorised by, and is in accordance with, the terms of the partnership deed, but which relates to any period (falling prior to the date of such partnership deed) for which such payment was not authorised by, or is not in accordance with, any earlier partnership deed, so, however, that the period of authorisation for such payment by any earlier partnership deed does not cover any period prior to the date of such earlier partnership deed; or
>
> (iv) any payment of interest to any partner which is authorised by, and is in accordance with, the terms of the partnership deed and relates to any period falling after the date of such partnership deed in so far as such amount exceeds the amount calculated at the rate of eighteen per cent. simple interest per annum; or
>
> (v) any payment of remuneration to any partner who is a working partner, which is authorised by, and is in accordance with, the terms of the partnership deed and relates to any period falling after the date of such partnership deed in so far as the amount of such payment to

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all the partners during the previous year exceeds the aggregate amount computed as hereunder:--

(1) in the case of a firm carrying on a profession referred to in section 44AA or which is notified for the purpose of that section--

(a) on the first Rs.1,00,000 book-profit or in case of a loss	Rs.50,000 or at the of the rate of 90 per cent of the book-profit, whichever is more;
(b) on the next Rs.1,00,000 of the book-profit	at the rate of 60 per cent;
(c) on the balance of the book-profit	at the rate of 40 per cent.;

(2) in the case of any other firm--

(a) on the first Rs.75,000 book-profit, or in case of a loss	Rs. 50,000 or at the of the rate of 90 per cent of the book-profit, whichever is more;
(b) on the next Rs.75,000 of the book-profit	at the rate of 60 per cent;
(c) on the balance of the	at the rate of 40 book-profit per cent;

Provided that in relation to any payment under this clause to the partner during the previous year relevant to the assessment year commencing on the 1st day of April, 1993, the terms of the partnership deed may, at any time during the said previous year, provide for such payment.

Explanation 1.--Where an individual is a partner in a firm on behalf, or for the benefit, of any other person (such partner and the other person

being hereinafter referred to as "partner in a representative capacity" and "person so represented", respectively),--

(i) interest paid by the firm to such individual otherwise than as partner in a representative capacity, shall not be taken into account for the purposes of this clause;

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(ii) interest paid by the firm to such individual as partner in a representative capacity and interest paid by the firm to the person so represented shall be taken into account for the purposes of this clause.

Explanation 2.--Where an individual is a partner in a firm otherwise than as partner in a representative capacity, interest paid by the firm to such individual shall not be taken into account for the purposes of this clause, if such interest is received by him on behalf, or for the benefit, of any other person.

Explanation 3.--For the purposes of this clause, "book-profit" means the net profit, as shown in the profit and loss account for the relevant previous year computed in the manner laid down in Chapter IV-D as increased by the aggregate amount of the remuneration paid or payable to all the partners of the firm if such amount has been deducted while computing the net profit.

Explanation 4.-For the purposes of this clause, "working partner" means an individual who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner.
... "

5.1. In Commissioner of Income Tax v. Gemini Productions (110 ITR 847), this Court, while dealing with the application of Section 10(4)(b) of the Income Tax Act, 1922, corresponding to Section 40(b) of the Income Tax Act, 1961, held as follows.

"For the application of section 10(4)(b) there must be income of the firm and out of the said income the firm should have made a payment by way of interest, salary, commission or remuneration to a partner of the firm. In this case, the company was carrying on an independent business of distribution of films produced by various persons including the assessee-firm and hence the income which the company received in the course of carrying on their business was the income of the company and not that of the persons whose pictures they are exhibiting. Therefore, the requirement for applying section 10(4)(b), namely, that the amount out of which the commission was paid must be the income of the firm of which the recipient is a partner, was absent in the instant case and appropriation of commission due to the company by it from and out of the realisations from the exhibition and distribution of films cannot be said to constitute "payment of commission" to a partner attracting section 10(4)(b)."

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5.2. Following the decision cited supra, the Andhra Pradesh High Court in Commissioner of Income Tax v. Chitra Kalpana (169 ITR 678), held as under.

> "Section 40(b) of the Income-tax Act, 1961, corresponds to section 10(4)(b) of the Indian Income-tax Act, 1922. Section 10(4)(b) was incorporated in the 1922 Act in the year 1939. The legislative history is sufficient to indicate that the provisions contained in section 40(b) of the Act are intended to prevent the siphoning off the firm's income to partners in order to reduce the tax liability in the hands of the firm. Income earned by the firm can be diverted into partners' hands by making payments on account of salary, bonus, interest, commission and other remuneration. Section 40(b) of the Act takes care of such attempts to avoid tax by making impermissible the deductions claimed by the firm as payments to partners on account of salary, bonus, interest, commission or remuneration, wherever a partner is under a legal obligation to provide his services or capital and yet charges a quid pro quo for such services or capital. Such payment made cannot be allowed while computing the firm's income because of section 40(b). Where, however, a partner is under no legal obligation to provide any particular service or involve himself in any particular activity, the payment made to him as a quid pro quo for such services and activities would not fall under section 40(b) of the Act. In other words, such a payment is a permissible deduction while computing the income of the firm."
>
> (emphasis supplied)

6. On the facts of the case, it was found that payments were not in their capacity as partners, but were made for the specific services rendered by them. Applying the ratio laid down in the aforesaid decisions, we have no hesitation to uphold the order of the Tribunal in holding that the payments made to the partner, by the assessee firm, cannot be disallowed under Section 40(b) of the Act. Accordingly, the question of law is answered in the affirmative and against the revenue. The appeal is dismissed.

kpl

Sd/
Asst.Registrar

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Sub Asst.Registrar

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To

1.The Commissioner of Income Tax
Tamilnadu IV
Madras.

2.The Income Tax Appellate Tribunal
Madras Bench (A)
Chennai.

3.The Commissioner
Income Tax (Appeal) IX
Madras-34.

4.The Asst. Commissioner of Income Tax
City Circle V (Inv) I
Madras-34.

AMB (CO)
RSM/31.7.2006

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